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Bear markets do not last unless coinciding with and independently induced by depressions in business. This is perfectly compatible with the influence which stock exchange events exert on consumers' spending.

—*Business Cycles*, Joseph A. Schumpeter, McGraw-Hill Book Comp., 1939

Unsustainable

For policymakers, businessmen and investors around the world, 1999 is shaping up as a year of great uncertainty. Despite the strong rebound of global stock markets from their summer 1998 lows, there remains a general uneasiness that another misstep in Brasilia, Tokyo or New York could tip a fragile world financial system.

The reason should be plain to all: unfolding world recession is crunching global credit. Net private capital flows to developing countries, excluding direct foreign investment, moved from plus \$94 billion in 1996 to minus \$27 billion in 1997 and minus \$60 billion in 1998. The surge of the yen and the collapse of the Japanese government bond market raise further awkward questions about international capital flows. Asia, Japan, Brazil and parts of South America are already in deep recession, and there is little reason to expect much of a recovery. However, the most important test will come, not in the vulnerable economies of the developing world or in Japan, but in the rich developed world that provides the bulk of international credit and sets the tone in global trade and financial markets—the United States and Europe. But the United States with its booming imports will unquestionably offer the most decisive test of all.

The question occupying us again in this letter is whether and when the U.S. bubble will burst. Presumably, the U.S. economy's remarkable resilience has played a key role in stabilizing the markets and the dollar. There is a widespread view that this exceptional economic strength reflects healthy fundamentals, among them stellar job and income growth. But job and income growth essentially hinges on one particular other condition to feed them, and that is higher credit-financed spending. There is one obvious, single explanation for the boom of the U.S. economy and the singular bull run of the stock market since 1995, in fact: the most rampant credit and money expansion ever.

EURO START

European Monetary Union is upon us despite very little or virtually no progress towards a political union. We have never liked it because we fail to see any credible leadership. But we have never shared the fears that the European Central Bank might pursue inflationary policies. Conservative Bundesbank thinking is pervasive today among all European central banks.

Creating one single currency for eleven independent countries with extremely varied economic structures and productivity levels is a venture unprecedented in the history of mankind. It is fortunate that its launch comes in benign circumstances of low inflation and moderate growth. However, two severe tests are already looming: slowing economic growth and a pronounced drop of the dollar. The latter is the greatest worry gnawing at corporate managers, policymakers and economists in Europe. It would batter exports, profits and stock markets. Consumers, on the other hand, should be clear winners of the EMU from the increased competition that will accrue from the greater transparency of prices.

BUT A DUBIOUS START IN GERMANY

In desperation, *The Economist* recently posed the question "Who's running Germany?...The answer, to date is...nobody." Rarely has a government had such a rotten start as the new red-green German government. As an election campaigner, Gerhard Schröder, was in every respect vacuous and vague. But most foreigners readily discarded this as a ruse, expecting him to show his true colors after the German people had elected him. To their utter surprise they now realize that Mr. Schröder's vacuity during the election campaign was by no means just an artifice to win the election but his true nature.

It was always clear that a red-green government would turn back the clock on economic policies. Tax plans are shifting money from the business sector to working families, with the declared aim of boosting consumption. But the miracle of a drastically reformed German economy and tax system was far from imminent under the old government. Either way, there is only marginal scope for change.

Conspicuously, a restoration of greater social justice was the Social Democrats' top theme in the election campaign. Oskar Lafontaine kept the party faithful happy with promises to overturn the Kohl government's very modest cuts in social welfare and earlier retirement, to tax energy use and to raise the incomes of the less well off. Wage restraint, he claimed, has been overdone. To boost domestic demand and to cut the horrendous jobless total of close to 4 million, in his postulate, calls for more purchasing power in the hands of low-income people. Emboldened by Mr. Lafontaine, trade unions are calling for a 6.5% wage rise (which they are sure not to get).

Actually, Mr. Lafontaine has a point. Over the last three years, hourly wages in Germany have increased a little less than 2% per annum. With average annual productivity gains of 5% in manufacturing, the slow rate of wage growth led to a brief, steep decline in unit labor costs by about 10%. Even in the economy as a whole, the annual wage rises slightly lagged the average annual productivity gain of almost 3%. But despite this wage restraint, the increase in unemployment was only stopped, not reversed. In light of this experience, wage moderation hardly appears to be an effective instrument in creating employment.

Does that mean that Mr. Lafontaine is right in pleading for higher wage increases to bolster consumer demand? No, it only confirms what reasonable people knew in advance, namely, that wage restraint is a device that cannot work in the short run because it implies a shift in the structural pattern of economic growth from capital-intensive to labor-intensive which, essentially, needs a very long time to develop.

The fact is that the relationship between wages and employment is much too tenuous to allow any predictions about employment effects in the short run. This arises from the circumstance that wages are both the biggest single cost factor of businesses and the biggest single source of purchasing power in the economy, on which businesses depend for the sale of their goods and services. A customary argument for existing unemployment is that high wages make production and employment unprofitable. In this light, cost and wage reductions appear the logical remedy.

But unfortunately, this is but another case of 'fallacy of composition,' about which we have repeatedly written in different contexts. It concerns the crucial difference between effects resulting from measures taken by single firms and effects resulting from the same measures taken by businesses as a whole. If single firms cut wages, it may be able to expand its output. However, once all businesses follow suit, the result is shrinking consumer purchasing power and shrinking output overall—frustrating any improvement in profits.

THE U.S. JOB MACHINE: CREDIT

More than anything else, it is the endless employment boom in the United States that has captured the envy

of politicians and observers, in particular in Europe, facing apparently intractable unemployment problems at home. Popular perception has it that America has accomplished its job miracle primarily with two things: first, protracted wage restraint and, second, a highly flexible labor market. In the 1970s and 1980s, in fact, wage rate rises in the United States almost always lagged the rise in consumer price inflation, implying a substantial fall in real wages, while in Europe—despite rising unemployment—the wage increases just as persistently outpaced escalating inflation, implying a surge in real wages. Europe's unemployment problem became structural.

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Wage restraint and a highly flexible labor market are unquestionably great positives for the U.S. economy and employment. But they would not have been sufficient to keep the economy booming. Its obvious key driving force since the early 1980s has been persistent, extremely strong credit growth. In the face of falling or stagnating real income, the American consumer decided to raise his living standards instead by piling up incredible amounts of debts. And obviously he succeeded. His borrowing more than compensated for his loss in current income.

The point to see is that booms are not made by wage policies, neither by falling nor rising wage rates. Booming economies and booming markets are made by one thing only, and that is rampant money and credit creation.

By the way, it should not be overlooked that this shift in the source of consumer spending power from wage growth to stronger consumer debt growth was magnificent grist to the profit mills of the business sector. Debt-financed consumer spending has the great advantage that it adds to business revenue growth without adding to the wage bill. Generally speaking credit is the most important profit source in every economy. American business is unbeatable in making maximum use of this profit source, driving the consumer into debt.

FEVERISH U.S. GROWTH

In connection with the bubbling financial markets this credit creation went to its greatest excess in the 1990s, as reflected most strikingly in the collapse of the personal savings rate from 5.7% in 1992 to 0.1% in the third quarter 1998. At present, this rate is even negative. In the past year, 85% of the increase in U.S. GDP came from consumption, compared with a normal 68%. That is, one-third of this extraordinary consumption growth was financed by plundering the savings rate.

Can America go on like this? Yes, but not indefinitely. The underlying money and credit expansion generates maladjustments that later need painful readjustments. These can be postponed for a while through ever larger credit injections. Just as the drug addict has to inject more and more drugs to postpone the painful withdrawal symptoms, such an overextended and unbalanced economy needs ever greater credit injections to keep growing. This is not healthy growth, this is feverish growth, spelling disaster.

A former governor of the U.S. Federal Reserve, Lawrence Lindsay, has in a recent article in *The Wall Street Journal* presented shocking calculations, showing where this development will lead in the next two or three years: Just to maintain the rate and pattern of economic growth, the personal savings rate would have to fall progressively: minus 1.5% in 1999, minus 3% in 2000 and minus 4.5% in 2001. Over these three years, U.S.

households would have spent \$720 billion more than they earned, and by 2002 would be drawing down their wealth at an annual rate of \$ 500 billion.

And what happens if U.S. households decide to stop at the present zero savings rate, implying that they spend all that they make but no more? GDP growth would slow every year by about 1.25%. In the year 2000, at the latest, the U.S. economy would be in recession, possibly deep recession, because investment spending would certainly not remain unaffected. In other words, to sustain its present growth the U.S. economy now depends on progressive dissaving.

WHY, MR. GREENSPAN?

For years, we have been warning that the U.S. stock market boom is a "bubble." By definition, asset price bubbles arise when money and credit expand well in excess of economic activity. The excess money ends up in the financial markets, propelling asset prices to unjustified and unsustainable levels completely out of proportion to the general price level.

In this way, U.S. stock valuations over the last year went from ridiculous to insane. The average P/E ratio of the companies in the S&P 500 has soared over the last year from 23 to 32, compared with a long-term average of 13.4. But what makes this valuation level wholly ludicrous is the associated zero savings ratio in the United States, providing compelling proof that the heavy stock buying had absolutely no relation to current savings but comes completely from credit creation and a flight from cash.

Up till now, the Fed has generously accommodated this bubble. Has it done so in ignorance or with a bad conscience? We would give Mr. Greenspan at least some benefit of the doubt. It was two years ago, in December 1996, with the Dow at 6500, when he first warned of "irrational exuberance," drawing wrath and ridicule from the rampant bulls. Meanwhile, he has repeatedly ruminated in public about unreasonable expectations. But he distinctly flinched from stronger warnings, dreading more Wall Street wrath. In traditional, conventional American thinking, any interest rates hikes in the face of stable or even falling inflation rates are completely out of the question. To be sure, trying to prick the bubble which the politicians and American public enjoyed so much, would have been suicidal for Mr. Greenspan.

Reportedly, the Fed has been very surprised by how quickly the stock market rebounded after its rate cuts. Allegedly, it had undertaken them for three reasons: *first*, to reassure both investors and politicians in America, *second*, to counter "unusual strains" in the capital markets *and third*, for fear that the global economy could not withstand a significant economic slowdown in the United States. Should the U.S. economy lose momentum and import less, the chances of a global recession would increase dramatically. This, in turn, would weaken U.S. economic growth still further.

Frankly speaking, we are anything but impressed by these arguments. In the first place, the leading central bank in the world ought to have understood beforehand that an interest cut by 75 basis point altogether is definitely not suitable to save the world economy from its troubles but that it might more probably stoke the old irrational exuberance in the markets. Which, indeed, it did temporarily. And as to the 'unusual strains' in the capital markets, we can refer to our comments to this point in the last letter. In October, when media stories about a credit crunch were at their most shrill, U.S. bank credit jumped at an annual rate of 29.5%. In the 13 weeks to mid-November U.S. M3 increased at an annualized rate of 16.3%, more than three times GDP growth.

That the Fed reacted so fast against this background of extremely rapid money and credit growth and a still booming economy, which in the third quarter had grown at an annualized rate of 4.1%, smacks to us rather of panic and a desperation to perpetuate the bubble by maintaining the inordinate money and credit growth, to

which the U.S. economy and its financial system have become addicted.

These considerations lead us to the conclusion that Mr. Greenspan must be terribly concerned. If he had perceived the U.S. economy as strong and healthy, he certainly wouldn't have implemented these cuts. But what are the consequences of this policy of desperation? Where does it lead to?

FROM STOCK MARKET BUBBLE TO BUBBLE ECONOMY

The trouble is that this policy does not merely prolong the bubble. It breeds greater trouble later. The longer a bubble lasts, the greater the damaging effects on the economy and the financial system. When governor Mieno of the Bank of Japan began to attack the Japanese asset bubble in late 1989 with rate hikes, even though consumer inflation was virtually zero, he explicitly said that he wanted to puncture it before it would burst of its own accord more violently and from even more extreme levels of overvaluation in stocks and property. The longer the suspension of reality, the greater the potential for later panic.

The U.S. stock market boom is a bubble of historic proportions. A so-called "bubble economy" develops when the soaring capital gains in the asset markets lead to serious excesses in borrowing and spending by businesses and consumers, distorting and maladjusting the economy's whole demand and output structures, actually producing more or less massive capital malinvestments and overconsumption. Essentially, such a bubble-driven boom can last only as long as the credit expansion progresses at an ever-accelerating pace. Putting it bluntly, for the overleveraged U.S. financial system and overheated economy, ever greater credit creation has become a necessity in order to avoid collapse.

All this once used to be commonplace to most economists. For most American economists today, though, the term "economic imbalance" is an incomprehensible word. In general, they focus on the inflation rate and nothing else as the measure of economic health and balance. If that rate is low or falling, the economy can't have any problem. We think that this extraordinary simplicity in economic thinking has been a necessary condition for this runaway boom in the stock market.

Typical in this respect is the reaction to the collapse of the personal savings rate into negative territory. Who cares? For Wall Street, it is a non-event, if not a highly positive event because the high-spending American consumer has become the very last pillar of U.S. and world economic growth. And Mr. Greenspan's attempts to maintain the consumer borrowing and spending binge by cutting rates, are commonly hailed. In our view, it is the policy of a desperado who wants to gain a short breathing pace at any cost.

For a thoughtful economist, it's a potentially disastrous development. In his WSJ article, ex-Fed governor Lawrence Lindsay states "By far the greatest cause for worry is the low rate of personal savings in the United States. Since October, that rate has been negative." There is no question that this collapse in the savings rate is highly correlated with the capital gains in the stock markets. Parts of these paper gains have been converted into income by selling stocks, while the accruing (unrealized) capital gains have encouraged and facilitated higher borrowing. These are the two ways dissaving materializes.

Apparently, the confluence of sharp stock market rebound and new boom in mortgage refinancings has extended the consumer borrowing and spending binge into the fourth quarter. Still, the fuel supply is rapidly diminishing. While major stock indexes did briefly hit new highs, it is a fact that most stock prices are now well below their level in July. Effectively, the artificial support to consumer spending through stock market capital gains has long evaporated, but so far the consumer remains in denial. However, proliferating profit warnings are giving traders and investors a taste of fright for the first time, after the brief euphoria about the rate cuts. For us, the spreading profit crunch and the escalating diffusion of bad news about the global economy are the death

sentence for the bull market in stocks, which, in turn, is the death sentence for the consumer borrowing and spending binge.

ANOTHER OMINOUS PARALLEL

In past letters, we have repeatedly emphasized that the present global economic situation has its historical parallel in 1929. A common feature is the precedence of an extraordinary international lending boom that fueled a synchronized global investment boom. The main global lender in the '20s, however, was the United States. But sharp rises in the U.S. call money rate for broker loans, financing stock speculation, drastically curtailed the American capital outflows from early 1928. Many deficit countries in Europe and South America had no choice but to restrain domestic demand. It was the first step toward world depression.

Speaking of another ominous parallel between the late 1920s and the present, we have another event in mind. It rather concerns the idea that the Fed's recent rate cuts were desirable to support the struggling emerging countries. Just think of Brazil's desperate fight to maintain its currency. In this view, these international considerations essentially had priority over any domestic considerations, including any apprehensions that new rate cuts would feed the bubble again.

We have a hard time swallowing so much American monetary altruism. In any case, it reminds us of an unfortunate parallel in history, which happened in 1927. In the summer of that year, three gentlemen from Europe arrived in great secrecy in New York for a secret conference with the governor of the Federal Reserve Bank of New York, Benjamin Strong. The names of the visitors were Hjalmar Schacht, governor of the German Reichsbank, Charles Rist, deputy governor of the Banque de France, and Montagu Norman, governor of the Bank of England.

The actual initiators of this conference, held at a secret place outside New York, were the American and the Briton. Their objective was to get the German and the French to go along with a concerted American-European policy of easier money. This had its specific reason in England. After the restoration of the gold standard in 1925, the British economy experienced in 1926 a disastrous general strike. As domestic production fell and imports soared, Britain ran a rapidly growing deficit with Europe. Being critical of an unremitting bank credit expansion in Britain, the European central banks did not want to accommodate this and tried to force the Bank of England into monetary tightening by converting sterling into gold. But the attempts of the Banque de France, the biggest creditor, met with wild British protests. Despite the strong credit expansion and its precarious reserve position, the Bank of England wanted to keep money as cheap as possible.

The alternative solution, pursued by Strong and Norman at the secret conference, was concerted monetary easing. However, Schacht and Rist flatly refused to participate. Schacht is reported to have said "Don't give me a low rate. Give me a true rate, and then I shall know how to keep my house in order." Following the departure of the two, Benjamin Strong forced the cheap money policy on the Federal Reserve, consisting of a cut in the discount rate from 4% to 3.5% and heavy purchases of government bonds, pumping liquidity into the banking system.

If these measures temporarily eased the pressure on the British financial system, this occurred at a terrible cost to the U.S. economy. The new money and credit created went rapidly into soaring securities and bank investments in securities. Virtually nothing of the new credit found its outlet in commercial loans or investment activities. But working through capital gains, the boom stimulated consumer demand. Alarmed by this development, the Fed soon reversed its policy, raising its rediscount rate again to 4% in February 1928, to 4.5% in May, and to 5% in July. Reserve tightening drove the call rate for stock exchange loans from under 4% in November 1927 to over 10% at the end of 1928.

However, the boom delirium had struck deep roots. The lure of easy stock market profits had caught the public imagination. Even though the call money rate rose temporarily to 20%, it failed to cool the boom. With its 1927 monetary easing, the Fed had definitely lost control over the financial system.

Back to the present. Mr. Greenspan's hasty rate reductions with reference to the weakness of the world financial system did strongly remind us of that action in 1927. For sure, Mr. Greenspan succeeded to spark a new, short bonfire in the stock market which helped to prolong the artificial U.S. consumer spending boom. This has bought a little time, while aggravating the imbalance.

Besides, we see one crucial difference between 1927 and today. In 1927, the monetary easing impacted an American economy and financial system that were still in excellent shape, with few or no valuation excesses yet in the system. The big economic and financial maladjustments and excesses were yet to happen. This time, the Fed's easing has been impacting an already highly vulnerable, grossly unbalanced economy with stock prices at insane levels. What is principally needed is gradual consumer retrenchment and gradual deflation of the equity bubble. But manifestly, the Fed is afraid to let this happen. Still, it achieved no more than a brief, albeit steep, bear market rally, but with the risk that worse is to happen later.

GLOBAL WEAKNESS SPREADS

Over the past two months, the booming financial markets have stolen the headlines. Meanwhile, the nonfinancial economies have quietly moved into a new, ominous phase. In October, the International Monetary Fund (IMF) slashed its global growth forecast for 1999 from 4.2% in May to 2%. The global implications of the Asian crisis were vastly underestimated for a long time.

Considering the rapidly spreading downward revisions in growth forecasts, there is now certainly more realism than before. It is accepted that economic activity in Latin America is declining fast, Brazil being the hardest hit. Russia is in a financial and economic meltdown. The savage contraction of Japan's private sector is accelerating. Though several Asian countries show some recovery from extremely low levels, thanks to improving trade balances, their actual situation still qualifies as depression. In Britain, recession has started. The United States and Europe, which have been the last bastions of economic growth, are now also slowing. In short, deterioration in almost every corner of the world.

After all, the great global credit and investment bubble is deflating. That's the common denominator of all these troubles. Several years of unprecedented credit excesses have created a global bubble of overcapacity, grossly overvalued assets, and widespread overindebtedness on national and international levels. Excess capacity inherently leads to goods deflation—and profit deflation. Above all, a glut of industrial capacity is plaguing the whole world.

JAPAN'S DOMESTIC SPENDING GAP

It is the traditional view of American economists that central banks have it in their power to prevent any recession by simply "printing money." The idea that recessions or depressions can be caused by preceding, unsustainable overinvestment, overconsumption and overindebtedness and that these structural maladjustments are not cured by lower interest rates, is completely alien to the thinking of the great majority of American economists. In their view, the Great Depression in the United States had its one single cause in the failure of monetary policy to expand the money supply, which supposedly would have been possible, if only the Fed had acted with more determination. What happened before the depression is in this view irrelevant. In the same vein, the present Japanese economic malaise is ascribed to nothing other than the failure of the government to cope

with the bad loans of the banks and the associated failure of the central bank to increase the money supply. In the last analysis, it's always incompetence that causes a crisis.

Of course, the banking mess which the government failed or refused to solve, has played an important role in depressing Japan's economy. Yet there is more to the crisis there than just the banking disaster. There is one pivotal structural difference between the economies of America and Japan and, by the way, Europe, too, which American economists completely fail to see. It concerns the tremendous differences in national personal savings rates. Personal savings are the gap between consumer spending and consumer income. Overall income growth, in turn, equals current output growth. By diminishing personal spending, saving essentially creates a domestic demand gap, which has to be filled by other kinds of demand.

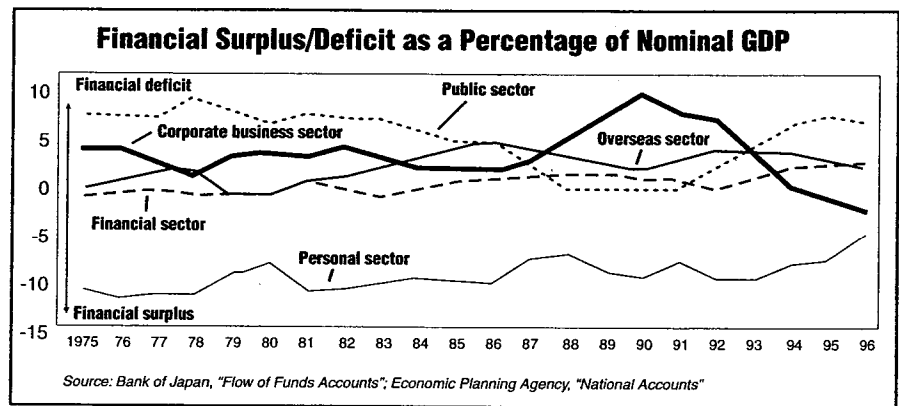
Japan's economy is traditionally and structurally a high-saving, high-investment economy. Its personal saving rate has in the past years consistently hovered between 13% and 14% of disposable income. France has lately a rate of 13.5%, and Germany of about 12%. The United States exhibits traditionally the opposite structure: low savings and a high consumption ratio. But this pattern has in the last years gone to a new extreme: personal savings went negative. The point to see is that this big discrepancy in national savings has enormous implications for economic policy.

In the past, Japan has filled its large savings-induced domestic demand gap by a high investment ratio and a large export surplus, yielding in conjunction a very healthy growth mix with high productivity growth and full employment. But this equilibrium was definitely destroyed, when the bubble economy developed. Business fixed investment, in particular, went during the bubble years to inordinate excess. When the bubble burst, in 1990, capital expenditures exceeded the internal business cash flow by no less than 9.1% of GDP, compared with an average financing gap in the past of about 3% of GDP.

Ever since, business investment spending has been in persistent, progressive decline, falling in 1994, for the first time ever, below the improving internal cash flow. Net investment has, apparently, become negative. Against the background of plunging profits, Japanese corporations are since then running a growing financial surplus. In 1996, this surplus hit 3.3% of GDP, implying a corresponding contraction of corporate domestic demand.

While U.S. domestic demand soared in 1998 by 5%, Japan's has shrunk 3.2%, with profits down 22%. But before we jeer at incompetent Japanese policies, we should first carefully identify the exact causes of the deepening depression. As already mentioned, these causes are of two kinds: *first*, the persistent, high propensity of private households to save which implies a low propensity to spend, as reflected in the pertinacious, double-digit personal savings ratio; *and second*, a protracted investment contraction occasioned by gross overinvestment during the bubble years and collapsing profits.

Instead of converting personal savings into investment spending, the business sector now adds to the opposite effect and adds to the huge savings surplus of the personal sector. The result is a combined spending



gap or financial surplus on the part of the private sector as a whole equivalent to about 9% of GDP. That's enough to make a depression. The investment deflation which first started in the stock and capital markets is translating into savage deflation in the capital goods industries themselves.

Japan's central bank has slashed its interest rates to virtually zero. But even in combination with massive governmental deficit spending, it has failed to stop, let alone reverse, the economy's contraction. The favorite explanation among American observers for this failure is the incompetence of the Japanese bureaucracy, having in particular failed to solve the banking crisis.

***“But shrinking investment spending essentially
curtails consumer income and spending.”***

For sure, the banking crisis is an important factor. But what's more, Japan's economies is in the throes of a severe, protracted structural crisis, being equally the manifest legacy of the bubble years. Given sharply slower demand growth, businesses have slashed their investment spending. But shrinking investment spending essentially curtails consumer income and spending. Trying to adjust to a lower level of capital expenditures, Japan's economy is caught in a cumulative downturn of investment and consumer spending which is very difficult to reverse.

EUROPE'S SIMILAR TROUBLES

Actually, Germany, France and most of Europe share this problem of a large savings-induced domestic demand gap with Japan, though at a more moderate scale. Like in Japan, the high savings were originally matched by strong business and residential investment. During the 1970s and 1980s, however, investment spending was in Europe increasingly crowded out and replaced by soaring government deficits. But as this outlet over time exhausted itself through rapidly compounding interest costs and as the EU-Maastricht treaty did put a limit on such deficit spending, Europe's savings surplus shifted in the 1990s progressively into a rising export surplus. This was reflected in a big swing in the EU current-account from an overall deficit of \$31 billion in 1990 to a mammoth surplus of \$105 billion after \$112 billion in 1997. Exports, actually, were Europe's engine of economic growth during these years. But this engine has broken down.

Considering America's outstanding success by boosting consumer spending through heavy consumer borrowing, it seems reasonable to recommend the same recipe to Japan, Asia and Europe. If in the face of the global capacity excess it no longer makes sense to stimulate investment spending why not switch policy to stimulate private consumption? In short, it won't work.

It won't work in the first place with the consumers in these countries. To save for the future, to save for the children is a thought deeply rooted in the character of the Asian and the Continental European. In this light, borrowing for consumption is still regarded as something undesirable. Correspondingly, the financial systems in these countries are simply not geared to big consumer lending. Typically, credit cards are not linked with credit. They are exclusively used as convenient payment instruments

In the major countries in Europe, the business cycle has clearly peaked in the third quarter. Real GDP growth is expected to slow to 2% in 1999 or slightly better, after 2.8% last year. That seems a moderate slowdown, but it will be centered in the industrial sector averaging about one quarter of Euroland GDP. Latest data suggest that the trend for industrial output is to go into negative territory. Given in that case rising labor unit cost again—after a sharp fall in the past years—but very little pricing power, there is every prospect of a profit squeeze, hurting both investment spending and stock prices. Any risks to the growth forecast are definitely on the downside.

WITHER THE U.S. DOLLAR?

Looking at the world economy and global financial markets, just two questions are uppermost in our mind: first, are there any inflation risks? And, more importantly, what will the valuation of the U.S. dollar against Europe's common currency, the euro be? As to the first question, we can only repeat with emphasis: Inflation is dead for the foreseeable future. True, the U.S. economy is driven by rampant credit. But the asset inflation that resulted is the regular harbinger of savage deflation, when the bubble bursts. With regard to the dollar, we have always stressed that it is in a secular downtrend, owing to the underlying spending excesses, but this downtrend is recurrently interrupted by recoveries that are linked to differences in the U.S.-European business cycle. The dollar strength since 1995 was clearly such a cyclical phenomenon. In times of strong U.S. economic growth and higher U.S. interest rates in relation to Europe, the dollar always tends to soar on the back of accelerating capital inflows. But in this respect, time is running out fast for the dollar.

Conversely, it just as certainly becomes winter for the dollar whenever the U.S. economy slows down and U.S. interest rates fall in relation to those in Europe. Under these conditions, U.S. capital inflows regularly decelerate faster than the trade deficit. With his three rate cuts in the face of an exploding trade deficit and a weakening dollar, Mr. Greenspan gave the clearest possible confirmation that he cares more about the stability of the U.S. financial markets than about the external stability of the U.S. currency.

How vulnerable, really, is the dollar? In our view, it is more vulnerable than ever. The seeds of its impending sharp fall have been sown in the big imbalances in the economy and in the U.S. balance of payments, both current and capital account.

The U.S. current account deficit has widened from \$148 billion in 1996 to \$166 billion in 1997 and a probable \$240 billion in 1998. No improvement but a further slight deterioration is expected in 1999. Combining the deficit on current account with a net outflow in foreign direct investment of about \$60 billion in 1998, the two components add up to a structural annual U.S. payments deficit of \$300 billion. Putting it differently: To keep the dollar stable, it needs an uninterrupted net capital inflow of roughly that amount.

The bull run of the dollar since 1995 indicates that during this time U.S. capital inflows persistently exceeded the rising current account deficit. Yet it appears that the sharp jump of this deficit in the wake of the Asian crisis has brought it to an inherently precarious level for the U.S. currency. Conspicuously, the dollar is sharply down from its peak against the Japanese yen and the European currencies, even though the U.S. economy and the stock market have performed exceedingly well by international comparison. Powerful rallies in U.S. stocks have not been imitated by the dollar, while market declines tend to weaken it.

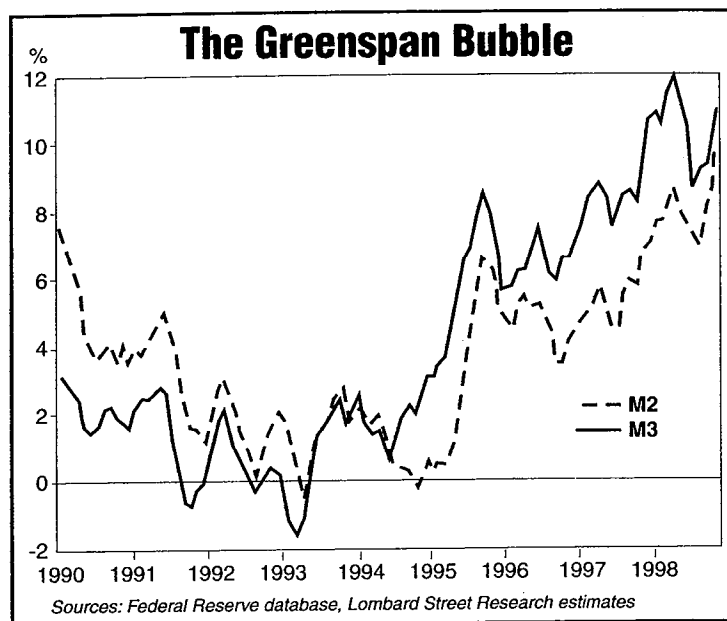
It is not difficult to identify two specific major changes in the U.S. capital balance accounting for this dollar weakness, in particular the sudden, steep plunge against the yen from 147 yen to 116 yen recently: *first*, and most obvious, the drastic curtailment of the international activity of American offshore hedge funds and proprietary trading desks of banks which had massively engaged in yen-carry trade, financing huge, heavily leveraged Treasury holdings with ultra-cheap yen. But once the liquidation of such positions began to drive up the yen, the whole bubble burst. The *second* dubious source of dollar strength in the past years was the vast purchases of U.S. securities by foreign central banks. Since the Asian crisis, these are major net sellers.

AN INHERENTLY UNSTABLE BOOM

Identifying imbalances is an indispensable key to longer-term economic forecasting. Imbalances are, in essence, unsustainable and prone to violent reversals. In the U.S. case, the major ill-boding imbalances are a negative personal savings rate, the huge and rising current account deficit, record-high consumer indebtedness

and a massive exposure of the private household sector to an extremely overvalued stock market. It goes without saying that these four imbalances are all interrelated. The stock market boom plays the crucial role among them, having propelled business and consumer spending to unsustainable, gross excess.

The economies of the United States and Japan have, in short, been mirror images. In the former, the bubbling stock market has driven the private sector (both business and consumer) into unprecedented spending in comparison to income and revenue which, in turn, has expanded the trade deficit. In Japan, just the opposite is happening since the bubble burst.



Yet, what is the cause of these imbalances? We can only repeat what we have so often stressed: every boom, every bubble has always but one possible cause: underlying money and credit excesses. The conclusive proof is in the following chart. Since 1995, U.S. money and credit growth is rampant as never before.

The most striking case of imbalance and unsustainable pattern is the worsening consumer spending binge, meanwhile outpacing the growth of household income. The negative savings rate means that American consumers are now spending more than 100% of their after-tax income, as stock market gains have supplanted traditional savings, and as household borrowing has also been speeding up.

There are many aspects to this development, but at this point we want to concentrate on the one, single aspect of sustainability. Is a negative savings rate sustainable? Our answer is: No, absolutely not. It spells certain disaster within the foreseeable future. There are three distinct sources of trouble:

First, just maintaining the present rate and pattern of U.S. economic growth, it would require progressive dissaving.

Second, the time of big capital gains in the stock market is definitely over, to say the least.

Third, the soaring trade deficit, resulting from the excess domestic demand, acts as a growing wedge between business revenues and business costs, increasingly squeezing profits. During the past year, the total wage bill paid out by companies has grown 6.3%, while nominal GDP has risen by only 4.5%. This unusual split between business revenue and business costs largely reflects the mammoth trade deficit implying a corresponding diversion of domestic purchasing power abroad, and most of this purchasing power comes essentially from the wage payments of businesses.

CONCLUSIONS

Global financial and economic prospects are bleak and fraught with risk for those who do not understand the inherent dynamics. Widespread faith that still easier money will restore economic expansion and the equity bull market is misplaced.

The spreading global crisis reflects the deflating of an international credit bubble which has created excess

capacity, grossly overvalued stock prices and excessive debt. By fueling strong U.S. domestic demand through extraordinary wealth effects, the Wall Street boom and the soaring U.S. trade deficit have become pivotal for the global economy. Their rise cannot last.

Stock markets have strongly rebounded from their October lows. Bull market psychology remains deeply entrenched. But the very breadth of the rally warns that the bull market has run out of steam. The great bull market is definitely over, considering deteriorating world economic prospects.

The greatest risk for the global economy and financial markets is a sharp slowdown of the U.S. economy and an associated prolonged sinking spell for the dollar. It would definitely usher in the Great Equity Bear Market.

A sharply weakening world economy will give support to government bonds in Europe and America but sharply widen credit spreads. For currency reasons, we give preference to bonds of the core countries in Europe.

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